New Approaches to LDC Debt Reduction and Disposition: U.S. Legal and Accounting Considerations

In spite of intense efforts on the part of developing nations, commercial banks, multilateral financial institutions, and the United States and other governments over the past six and a half years, the international debt crisis persists with few signs of amelioration. Since the crisis erupted in 1982, total external indebtedness of the developing countries has increased from $831 billion to an estimated $1,320 billion in 1988.\(^1\) The total external debt of the highly indebted countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ivory Coast, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, The Philippines, Uruguay, Venezuela, and Yugoslavia) amounted to $529 billion at the end of 1988.\(^2\) Per capita income of the highly indebted developing countries has fallen dramatically during the 1980s, as much as 5 percent per year in some cases, in spite of six years of economic expansion in the industrial countries.\(^3\) Net financial transfers to the highly indebted countries, that is, the excess of new loans over debt service payments, has been estimated at a negative $11 billion in

\(^{2}\) Id.
1987.\(^4\) In light of these statistics, it is not surprising that social and political turmoil in these countries is increasing as evidenced by the riots in Caracas in February of 1989.

Ironically, although experiencing a period of sustained domestic economic growth, the United States has become in recent years the world's largest debtor nation. At the end of 1987, the net international investment position of the United States was a **negative** $400 billion, as compared to a **positive** $260 billion for Japan and $165 billion for Germany.\(^5\) Some of the capital flowing into the United States is coming, of course, from the developing nations. For the first time in fifty years, foreigners earned more in 1987 on their investments in the United States than Americans earned on their investments abroad. In brief, the Third World has sunk deeper into debt, per capita income has declined, and developing countries that should be importing capital to fuel economic growth are exporting it to the developed nations.

Fortunately, U.S. commercial banks have during this same period substantially increased their capital and dramatically increased their loan-loss reserves, so that they are now in a much better position to absorb any losses that may result from their LDC loans. As a result, after years of tedious debt reschedulings and forced new money exercises, the commercial banks have now moved beyond the "muddling through" stage and have begun actively to manage and reduce their debt portfolios.

Instead of passively holding on to their debt for what could be forever, banks have begun aggressively to pursue various alternatives in the management of such debt:

1. **Selling** debt in the secondary market, at increasingly greater discounts;
2. **Swapping** debt of one sovereign nation for that of another in order to concentrate their debt in those countries with which they feel most comfortable;
3. **Converting** debt into equity investments in the debtor nations; and
4. **Exchanging** debt for securitized and/or collateralized debentures or other debt instruments.

Because of their relatively weaker capital positions and greater desire to maintain a long-term financing role in the debtor nations, the money-center banks generally have been less willing and able than regional banks to sell or trade their LDC debt. Straight debt sales or debt swaps, both of which will result in substantial losses to a bank, are thus less attractive to money-center banks than to regional and foreign banks. By contrast, conversion of debt to equity interests may be more attractive to money-center banks than to regional banks because such conversions usually involve less of an accounting loss, require a long-term interest or commitment to the developing countries, and necessitate a continued presence

\(^4\) See Department of the Treasury, First Report to the Congress Concerning World Bank Strategy and Lending Programs in Debtor Countries 18 (Mar. 1989).
in developing countries that most regional and foreign banks lack. Thus, in terms of their goals, the banks tend to fall into two categories. One group of banks seeks to cash out its loan positions and take whatever losses may result, while the other is more inclined to convert some of its debt into equity or other debt instruments that may provide a more profitable and flexible long-term investment than existing debt.

The primary goal of the debtor nations is to reduce the amount of principal and/or the rate of interest payable on their debt so that their remaining debt can be serviced under reasonably normal circumstances without undue adverse effect on economic growth. The amount of reduction of principal and/or interest necessary to accomplish this objective will vary greatly depending upon the particular circumstances of each country. No single scheme for debt relief, if available to banks on a voluntary basis, is sufficient to enable the debtor nations to meet their interest obligations comfortably. Nonetheless, significant debt relief can be accomplished through a combination of debt/equity conversions, debt-forgiveness arrangements similar to the recent Mexican debt exchange offer (the Mexican Debt Exchange), debt buy-backs, and/or reductions in the rate of interest payable on the countries’ debt.

The quickest and most efficient way to achieve meaningful debt reduction is to enable the debtor nations to capture to the fullest extent possible the discount at which their debt is selling in the secondary market. Such discount ranges from 96 percent for Peru, down to about 40 to 45 percent for Chile and Colombia, the better credit risks in Latin America today. If banks are willing (as many have been) to sell their LDC debt at the substantial discounts prevailing in the secondary market, debtor nations should be encouraged to acquire their own debt, thereby cancelling and eliminating the accompanying debt service obligations. Debt/equity conversions and exchanges similar to the Mexican Debt Exchange are also designed in part to enable debtor nations to capture some of this discount for their own benefit.

The new U.S. debt policy announced by Secretary of the Treasury Nicholas Brady on March 10, 1989, recognized publicly for the first time the United States Government’s belief that debt reduction (i.e., forgiveness of part of the principal on the LDC debt) is essential to the solution of the debt problem. To implement such debt reduction proposal, Secretary Brady encouraged the debtor nations and their creditor banks to undertake several types of transactions:

- debt buy-backs;
- exchanges of old debt for new longer-term collateralized debt instruments; and
- debt/equity conversions.

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To facilitate and encourage such debt reduction transactions, Secretary Brady proposed that The World Bank and International Monetary Fund dedicate a portion of their policy-based loans to replenish reserves used by the debtor nations to buy back their debt and to finance the purchase of collateral to secure new collateralized debt instruments issued in exchange for old debt. Secretary Brady also suggested that The World Bank and IMF could provide additional financial support to collateralize a portion of the interest payments (such as twelve months of interest payments on a rolling forward basis) on new debt issued in debt reduction transactions.

Participation by a U.S. commercial bank in a straightforward buy-back by a debtor nation of its debt does not raise complicated legal or accounting issues for the banks. The banks would simply sell their debt at a discount from its par value (and perhaps the carrying value on its books), suffer the resultant accounting loss, and make the appropriate adjustments, if any, to its reserves. Debt/equity conversion transactions and debt exchanges involving new collateralized bonds, which are two of the more promising and innovative approaches to managing and reducing the LDC debt, do, on the other hand, involve substantial legal and accounting issues for U.S. banks, and these issues are analyzed in the following sections.

I. Debt/Equity Conversions

A. The Structure of a Debt/Equity Conversion

The simplest, most straightforward debt/equity conversion occurs when a creditor of a company exchanges or converts the debt owed to it by such company for an equity interest in the same company. Such conversions are not common since they require that the creditor itself have an interest in acquiring equity in its debtor. Such interest is likely to exist only where a foreign parent of a local subsidiary seeks to capitalize the loans it has made to the subsidiary.

Debt/equity conversions are more likely to occur as a two- or three-part transaction. First, a foreign bank creditor holding public sector debt sells such debt to the Central Bank of the debtor country for local currency equivalent in amount to the face value of the external debt, or at some pre-established discount. The bank creditor then takes such local currency and uses it to acquire an equity interest in a company in the debtor country. This is essentially what Bankers Trust did when it converted approximately $60 million of Chilean public sector debt (consisting partly of debt that Bankers Trust held in portfolio and partly of debt that it purchased from other lenders) into shares of a Chilean pension fund and an affiliated insurance company.

Some bank lenders may not be interested in converting the debt they hold into equity and, indeed, may be prevented from doing so by applicable banking regulations. A three-step transaction involving a multinational corporation may instead be effected. The foreign bank lender initially sells public sector (or
possibly even private sector) debt to a multinational company, usually at a significant discount depending upon the particular country involved. The multinational corporation then exchanges, usually with the debtor nation’s central bank, such dollar denominated debt for local currency equal in amount to the face value of the debt exchanged or at some fixed or auction-determined discount. Finally, the multinational company invests the local currency in a domestic company, which may well be its own subsidiary.

B. United States Banking Laws and Regulations Affecting Debt/Equity Conversions

1. The Basic Framework

The acquisition of an equity interest in a foreign company through a debt/equity conversion or otherwise by a U.S. banking organization may be subject to the Federal Reserve Act (FRA), the Bank Holding Company Act (BHCA), and Regulations K and Y of the Board of Governors of the Federal Reserve System (the Board). Pursuant to section 25 of the FRA, a member bank may invest directly in Edge Act corporations and Agreement corporations. Since a member bank generally may not own directly other types of foreign equity investments, the acquisition of stock by a U.S. banking organization usually must be effected through a bank holding company (BHC) or through an Edge Act corporation.

Section 4(c)(13) of the BHCA permits BHCs to acquire shares of any foreign company that:

- does no business in the United States except as an incident to its international or foreign business, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of [the BHCA] and would be in the public interest.

Section 25(a) of the FRA provides for the establishment of Edge Act corporations and authorizes them to engage in activities overseas that the Board considers to be usual in connection with the business of banking in foreign countries. Edge Act corporations may also, with the consent of and subject to the regulations of the Board, own shares of any foreign company provided that such company is “not engaged in the general business of buying or selling goods . . . in the United States and [is] not transacting any business in the United States

9. Id. §§ 1841–50.
11. Id. §§ 225.1–.43.
14. § 1843.
15. §§ 611–631.
except such as in the judgment of the Board . . . may be incidental to its international or foreign business.\textsuperscript{16}

The Board has set forth extensive regulations implementing the foregoing provisions of the FRA and the BHCA in Regulation K.\textsuperscript{17} Since Regulation K will govern most debt/equity conversions, the pertinent provisions of Regulation K will be described in detail below.

In addition to section 4(c)(13), several other provisions of the BHCA may be relevant to the acquisition of an equity interest in a foreign company. Section 4(c)(6) of the BHCA permits a BHC to hold not more than 5 percent of the outstanding voting stock of any company, irrespective of the nature of its business and where it engages in such business.\textsuperscript{18} Additionally, section 4(c)(7) of the BHCA permits a BHC to hold shares (without any percentage limitation) of an investment company, provided that such company is engaged only in the business of investing in securities and that it does not hold more than 5 percent of the outstanding voting stock of any company.\textsuperscript{19}

Finally, a U.S. banking organization may acquire an equity interest in a company without limitation as to the nature of the business of such company or the percentage amount of voting stock being acquired if such acquisition is necessary to prevent a loss on a "debt previously contracted." Such "dpc" exception to the general limits on the acquisition by banking organizations of equity interests in companies is found in the National Banking Act,\textsuperscript{20} the FRA in respect of Edge Act corporations,\textsuperscript{21} the BHCA,\textsuperscript{22} Regulations K\textsuperscript{23} and Y\textsuperscript{24} and various state banking laws.

2. Regulation K

On February 18, 1988, the Board announced a major liberalization of Regulation K designed to facilitate equity investments by U.S. banks in foreign countries through the use of debt/equity conversions.\textsuperscript{25} This amendment expanded the scope of an August 1987 amendment to Regulation K,\textsuperscript{26} which permitted banks, through debt/equity swaps, to own up to 100 percent of nonfinancial companies acquired from the government of a heavily indebted developing country. The prior liberalization, which permitted banks, in effect, to buy privatized companies, had been criticized widely as being of limited use and

\textsuperscript{16} Id. \S 615(c) (1982).
\textsuperscript{17} 12 C.F.R. \S 211.5 (1988).
\textsuperscript{19} Id. \S 1843(c)(7).
\textsuperscript{20} Id. \S 615(c) (1982).
\textsuperscript{21} Id. \Ss 21–213.
\textsuperscript{22} Id. \S 615(c) (1982).
\textsuperscript{23} Id. \S 615(c) (1982).
\textsuperscript{24} Id. \S 211.5(e) (1988).
\textsuperscript{25} Id. \S 211.5(f), 3 Fed. Banking L. Rep. (CCH) \# 31,451 (Mar. 4, 1988).
perhaps even misguided in its ultimate effect. The new amendment extends the authority, already generally available to banks under Regulation K, to make certain equity investments through debt/equity conversions.

a. General Equity Investment Authority

Regulation K sets forth the Board’s long-standing policy that foreign investments made by BHCs, member banks, and Edge and Agreement corporations (which are collectively defined in Regulation K, and will be referred to hereinafter as Investors) pursuant to the BHCA and the Edge Act should be limited primarily to organizations whose activities are “confined to those of a banking or financial nature and those that are necessary to carry on such activities.”

(i) ‘‘Permissible Activities.’’ Regulation K sets forth a list of those activities that are considered ‘‘usual in connection with the transaction of banking or other financial operations abroad’’ and that are considered to be ‘‘permissible activities.’’ These include:

1. commercial and other banking activities;
2. commercial and consumer finance;
3. lease financing;
4. providing investment, financial or economic advisory services;
5. data processing;
6. managing a mutual fund that does not exercise managerial control over the firms in which it invests;
7. management consulting;
8. underwriting or distributing securities outside the United States; and
9. activities the Board has determined to be closely related to banking under section 4(c)(8) of the BHCA.

In addition to these listed permissible activities, the Board, upon application by an Investor, may approve other activities if the Board finds them to be banking or financial in nature, or finds that other financial institutions in the foreign country in question engage in such activities, and determines that for competitive reasons Investors should also be permitted to engage in such activities.

(ii) Eligible Investment Levels or Categories. An Investor may acquire up to 100 percent of the voting stock of a foreign company provided that 95 percent or more of its activities are listed permissible activities or have been specifically determined to be permissible by the Board. An Investor may also acquire lesser amounts of voting stock in a company even though it engages to a significant extent in nonpermissible activities. More specifically, an Investor may make investments in the following types of companies to the extent indicated:

(a) Acquire more than 50 percent of the voting stock of a foreign entity or acquire control of such entity (a ‘‘subsidiary’’ investment), provided that at least 95 percent of such entity’s assets or revenues relate to permissible activities that are enumerated in Regulation K or have been determined by the Board to be permissible;
acquire 20 percent or more of the voting stock of a foreign entity but not a controlling interest (a "joint venture" investment), provided that at least 90 percent of the assets or revenues of such company relate to permissible activities;

c) acquire less than 20 percent of a foreign entity (a "portfolio investment") irrespective of what activities the company engages in, provided that the aggregate amount of all such portfolio investments by the Investor does not exceed the Investor's capital plus surplus.

(iii) Requirement of Divestiture. An investor will be required to divest an investment (unless the Board authorizes retention) if the company in which the investment is made (a) engages in the general business of selling goods, wares, merchandise, or commodities in the United States; (b) engages directly or indirectly in other business in the United States that would not be permitted to an Edge Act corporation; or (c) engages in impermissible activities to an extent not permitted by the regulations. Thus, in addition to making sure that the company in which an Investor seeks to invest fits within one of the eligible investment categories, an Investor must also make sure that such company's activities in the United States are narrowly circumscribed.

Even if a foreign company's activities in the United States exceed such limits so that investment in such company would not be permitted under Regulation K, nonetheless, an Investor can always hold up to 5 percent of the voting stock of such company pursuant to section 4(c)(6) of the BHCA regardless of its activities.

(iv) Notice and Consent Requirements. Depending upon the magnitude and nature of the proposed investment, an Investor's acquisition will be subject to the Board's general consent procedure or to its prior notice, or specific consent, procedure.

Assuming that an Investor's proposed investment fits within one of the subsidiary, joint venture, or portfolio investment categories described above, no prior notice need be given to the Board of the proposed investment if the investment in such entity does not exceed the lesser of $15 million or 5 percent of the bank's capital plus surplus.

An investment that fits within one of the three investment categories, but exceeds the level permitted for general consent, may be made pursuant to the prior notice procedure. Under this procedure, the Investor must give the Board forty-five days' prior notice of its intention to make such investment, during which time the Board may object to the investment.

An investor must seek the specific consent of the Board to an acquisition if its proposed acquisition does not come within the general consent or prior notice provisions. Such consent is essentially required where the Investor seeks to acquire more than a portfolio investment in a company whose activities are not included within the Board's list of permissible activities.
b. The February 1988 Amendment

The February 1988 amendment liberalized the authority of BHCs to make equity investments in developing countries through debt/equity conversions by: (i) increasing the amount of equity ownership a BHC may have in a nonfinancial company; (ii) permitting the BHC to provide loans, in addition to equity, to such company; (iii) extending the time period during which the equity investment may be retained by the BHC; and (iv) liberalizing the general consent procedures.

(i) Permissible Equity Investments. In addition to investments permitted under other provisions of Regulation K, a BHC may now make the following equity investments through a debt/equity conversion:

- up to 100 percent of the shares of any foreign company, which shares are acquired from the government of the country or its agencies or instrumentalities (i.e., a privatization of a public sector company); and

- up to 40 percent of the shares of any private sector company, provided that:
  
  (A) a BHC may acquire more than 25 percent of the voting shares of such company only if another shareholder or control group of shareholders not affiliated with the BHC owns a larger block of voting shares of such company; and
  
  (B) the BHC may not have a greater representation on the board of directors or management committees of the foreign company than is proportional to the shares it holds in such company.

By permitting a BHC to own up to 25 (and under certain circumstances up to 40) percent of the voting shares of the foreign company, the Board enabled BHCs to have not merely portfolio, but "operational," investments in private sector nonfinancial companies. The Board believes that BHCs will be able to have an important voice in the management of the companies through proportionate, noncontrolling representation on their boards of directors. A BHC should be able to protect its investment in a nonfinancial company, the Board feels, without having the sole operational control over the company, which a BHC is ill-equipped to exercise. Also, holding 20 percent or more of the shares of nonfinancial companies will allow BHCs to use consolidation or equity accounting, rather than cost accounting, in respect of such investments.

(ii) Permissible Debt Financing. If a BHC acquires 20 percent or more of the voting shares of a nonfinancial private sector company, it will not be permitted to extend loans or other forms of financing to such company in excess of 50 percent of the total loans or extensions of credit to such company.

(iii) Permissible Holding Period. BHCs will be permitted to retain investments made pursuant to debt/equity conversions for a period of two years beyond the end of any period established by the host country restricting the repatriation of such investment, but in no event for more than fifteen years. This holding period will apply to investments in both public and private sector companies. Its imposition reflects the Board's view that investments of 20 percent or more in the
voting stock of nonfinancial companies are intended to be temporary, and
upholds the Board's general objective of maintaining the separation between
banking and commerce. The divestment requirement at the end of the holding
period is not applicable, however, to investments otherwise permissible under
Regulation K, even if such investments resulted from debt/equity conversions.

(iv) General Consent Procedures. The Board grants a general consent to
investments made pursuant to the February 1988 amendment if the total amount
invested does not exceed the greater of $15 million or 1 percent of the equity of
the BHC. Prior notice to, or the specific consent of, the Board is required,
however, if a country's debt/equity conversion program requires the BHC to
invest new money after converting debt obligations to equity, if the amount of
such new money exceeds $15 million or if the investment is to be made through
an insured bank or its subsidiary.

(v) Investments to Be Held through the Holding Company. Debt-for-equity
investments in nonfinancial companies are required to be held through a BHC and
not directly by a bank or a subsidiary of a bank. The Board thus sought to protect
banks from the potential risks of investments in commercial and industrial com-
panies, and to make it clear that the federal safety net does not apply to nonbanking
activities. The Board is willing, however, to grant exceptions to this general
requirement on a case-by-case basis if it can be demonstrated that there is a special
reason (e.g., local legal requirements) why a bank, rather than a BHC, must hold
the investment in the nonfinancial company.

(vi) Private Sector Debt Not Eligible for Debt/Equity Conversion. Despite
comment urging the contrary, the Board has limited application of the liberalized
investment rules to equity investments made through the conversion of sovereign
debt, thus excluding the swapping of private sector debt. In support of its
position, the Board noted that a bank can already convert private sector debt to
an equity investment through the use of the 'debt previously contracted' exception,
whereas, according to the Board, sovereign debt is not eligible for
such conversion.

(vii) Some Observations on the February 1988 Amendment. Although the
February 1988 amendment provides a useful liberalization of Regulation K, the
ability of banks to do debt/equity conversions has not been significantly
enhanced. BHCs may now own up to 25 percent of the voting stock of a
nonfinancial company (or up to 40 percent if another stockholder holds a larger
block), whereas previously they were limited to less than 20 percent. The power
to acquire this relatively small additional amount of voting stock has, however,
been coupled with limitations on the permissible holding period of the invest-
ment, the amount of debt financing that may also be provided, the manner in
which the investment may be held, and the type of debt that is eligible for
conversion.

The Board in its August 1987 amendment permitted BHCs to acquire 100
percent of a public sector company pursuant to a debt/equity conversion. Since
public sector companies are likely to have been less well-managed than private sector companies, the acquisition of a 100 percent interest in a private sector company would present less commercial risk to a BHC than a public sector company and should, a fortiori, also be permitted. Such treatment would be consistent with the purpose of the "debt previously contracted" exception described below, namely, to enable a bank to exchange debt for an equity interest, without limit as to the percentage of voting stock, if the bank believes such exchange is a reasonable step toward collecting on its loan. The "dpc" exception is a very limited but well-established departure from the general principle of the separation of banking and commerce. The Board would, therefore, have ample precedent for permitting BHCs to acquire up to 100 percent of private, as well as public, sector companies.

C. OTHER LEGAL BASES FOR HOLDING AN EQUITY INVESTMENT IN FOREIGN COMPANIES

Assuming that an Investor cannot make an investment under the eligible investment categories of the newly amended Regulation K, there are nonetheless several alternative legal bases on which an Investor may rely to acquire equity in a foreign company. The most flexible of these is the "dpc" exception, which permits an Investor to acquire an equity investment in exchange for a "debt previously contracted." Of more limited use to an Investor are two exceptions to the general prohibitions of the BHCA that permit an Investor to acquire directly, or indirectly through an investment company, up to 5 percent of the voting stock of a company.

1. The "Debt Previously Contracted" Exception

The "dpc" exception permits a banking organization to acquire up to 100 percent of the voting stock of a company in exchange for a "debt previously contracted." "Dpc" exceptions to limitations otherwise imposed by the banking laws are found in Regulation K, the BHCA, Regulation Y, the FRA, and in state law.

a. Regulation K

Pursuant to the "dpc" exception set forth in section 211.5(e) of Regulation K, equity interests acquired in exchange for "debt previously contracted" are not subject to the limitations of Regulation K provided that:

(i) such equity is acquired in order to "prevent a loss on a debt previously contracted in good faith"; and

(ii) such equity interests are disposed of no later than two years after their acquisition, unless the Board authorizes retention for a longer period.

The "dpc" exceptions set forth in the BHCA and Regulation Y are very similar to that of Regulation K except that they permit the Board to authorize the retention by the BHC of conversion-generated shares for a maximum period of five years, whereas Regulation K contains no such absolute limit.
By means of the "dpc" exception, an Investor may acquire an unlimited amount of the voting stock of a foreign company irrespective of whether such company engages in non-"permissible" activities. Thus, an Investor could acquire voting stock in a company engaged to a substantial extent in non-"permissible" activities such as manufacturing, mining, or tourism.

Whether the "dpc" exception is available will depend upon the facts of the particular case. Generally speaking, this provision has been used to permit the conversion of debt into equity of the same debtor or into equity that served as collateral for the debt in question. The language of Regulation K, however, does not on its face preclude a conversion into equity of a third party.

Some members of the staff of the Board, however, have apparently taken a somewhat restrictive view of the "dpc" exception, suggesting that it may not be used to permit the acquisition of equity in exchange for debt of a sovereign nation. Their reasoning appears to be twofold. First, the "dpc" exception should be limited to debtors that are bankrupt or have been declared in default. Although some debtor nations may be in arrears on their obligations, they have not been declared in default and, therefore, their situation is considered to be not so serious as to justify "dpc" treatment. Second, there is concern as to how the remainder of a banking organization's portfolio of debt of a particular country should be treated if some of such debt has been converted to equity "in order to prevent a loss."

The language of Regulation K, however, does not necessarily compel such a restrictive interpretation. If a banking organization were to sell a particular loan in the secondary market or swap it for debt of another Third World debtor it would incur a loss that, depending on the discount at which such debt is selling, may be substantial, irrespective of whether the debtor was bankrupt or had been declared in default. Moreover, if it were to incur a loss on such transaction, it would not necessarily be required to write down the rest of its portfolio of such debt. Thus, by effecting a conversion of debt to an equity investment, a banking organization not only might be able to "prevent a loss," but would also not necessarily have to write down any remaining debt of the same debtor held in its portfolio.

b. The National Banking Act

Even if the Board will not permit a BHC to undertake a conversion of debt to equity pursuant to the "dpc" exception, the bank itself may be able to effect such a transaction directly. Ordinarily debt/equity conversions will be effected either at the holding company level, i.e., by the BHC itself, or by a nonbank subsidiary of the BHC. If, however, the debt is held by the bank and is converted by it, then the applicable laws and regulations will instead be, in the case of a national bank, the National Banking Act and the regulations of the Office of the Comptroller of the Currency (OCC) and, in the case of a state bank, state laws and regulations. The OCC has interpreted the "incidental powers" clause of the
National Banking Act as permitting the exchange of debt for equity if the bank believes in good faith that such exchange is a reasonable and appropriate step toward collecting a bank's loans. The OCC has also relied on the powers of a national bank to hold real property received in satisfaction of a debt previously contracted in cases where the equity in question was in a real estate holding company. The OCC is apparently prepared to give considerable weight to a bank's determination that the exchange of debt for equity is reasonably necessary to salvage the bank's assets.

The OCC's interpretation of the National Banking Act as permitting "dpc" transactions is elaborated upon in two recent "No Objection" letters issued in 1987 and 1988 involving, in the first instance, an investment in a Mexican holding company whose sole asset is a Mexican hotel and, in the second instance, an investment in a Chilean insurance company. If a "dpc" transaction is undertaken by a national bank pursuant to its inherent powers under the National Banking Act, no approval or "No Objection" letter is required to be obtained from the OCC. Nonetheless, the interpretations set forth in the above-described "No Objection" letters will provide useful guidance to banks making an equity investment in reliance on such powers.

c. New York State Banking Law

Under New York law, a bank "may invest in and have and exercise all rights of ownership with respect to . . . so much of the capital stock of any other corporation as may be specifically authorized by the laws of [New York] or by resolution of the banking board upon a three-fifths vote of all its members." Additionally, [a] bank or trust company may acquire stock in settlement or reduction of a loan, or advance of credit or in exchange for an investment previously made in good faith and in the ordinary course of business, where such acquisition of stock is necessary in order to minimize or avoid loss in connection with any such loan, advance of credit or investment previously made in good faith.

The New York State Banking Department takes a flexible attitude in permitting the acquisition of stock for a debt previously contracted. If the bank reasonably believes the acquisition of equity in exchange for debt is necessary in order to minimize or avoid a loss in connection with a loan, and the transaction is not a subterfuge, the Banking Department will not object.

28. Id. § 29.
31. Id.
2. **Section 4(c)(6) of the BHCA**

Assuming a banking organization cannot effect a debt/equity conversion in reliance on Regulation K because the target company is engaged in more than incidental business activities in the United States or in reliance on the "dpc" exception, it still will be permitted to acquire up to 5 percent of the voting stock of any company pursuant to section 4(c)(6) of the BHCA. This exception is self-executing and accordingly no prior notice to, or consent by, the Board is required. The exception is available irrespective of the nature of the business in which the company is engaged or the extent of its activities in the United States. Such investments, however, are required to be passive and should not involve active participation by the Investor in the management of the company.

3. **Effecting Debt/Equity Conversions through Investment Companies**

Section 4(c)(7) of the BHCA permits a BHC to hold up to 100 percent of the shares of an investment company that is not engaged in any business other than investing in securities, provided that such securities do not represent more than 5 percent of the outstanding voting stock of any company. No comparable provision is contained in Regulation K and the Board has not been called upon to determine what rules would pertain to the acquisition by an Investor of shares in an investment company that invested solely in foreign equity securities.

Since a BHC may acquire up to 25 (and under certain circumstances up to 40) percent of the voting shares of a nonfinancial company, presumably a BHC could acquire shares in an investment company that, in turn, could hold at least such percentage amount of voting stock of a company. Query whether a BHC could hold up to 25 (or 40) percent of the shares of an investment company which, in turn, could hold any amount of the voting stock of a company? The Board's reaction to such a proposal and variations thereof may depend, in part, on the extent to which the BHC has excessive operational control over the company in which the investment company is investing or whether, through the use of the investment company vehicle, the BHC is, indirectly, investing in the target company with one or more substantial joint venture partners that can bring managerial and/or technical expertise to the investment.

C. **U.S. Accounting Treatment of Debt/Equity Conversions**

1. **Debt-for-Equity Swaps**

With Regulation K having been partially liberalized, perhaps the most significant U.S. regulatory obstacle to debt/equity conversion is U.S. accounting treatment. The proper accounting treatment for a debt/equity conversion has been the subject of considerable uncertainty and controversy. Recently, however, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA) and the AICPA Banking Committee have reached substantial agreement on the appropriate treatment and have released...
AcSEC Practice Bulletin No. 4 dealing with "Accounting for Foreign Debt/Equity Swaps." Under the AcSEC Bulletin, a debt/equity swap will be treated as an exchange transaction of a monetary asset for a nonmonetary asset, which latter asset is to be reflected at its "fair value" on the books of the bank or BHC as of the date the transaction is agreed to by both parties.

What is "fair value"? The Bulletin states that to determine "fair value" one should consider the fair value of the consideration given up, i.e., the old debt, as well as the fair value of the assets received, i.e., the equity investment, especially if the value of the consideration given up is not readily determinable or may not be a good indicator of the value received. The AICPA notes that since the secondary market for debt of financially troubled countries is thin, that market may not be the best indicator of the value of the equity investment received. Therefore, the AICPA committees concluded that, to determine the fair value of the equity received in a debt/equity conversion, both the secondary market price of the debt given up and the fair value of the equity investment received should be considered. The following factors should be considered in determining current fair value:

- similar transactions for cash;
- estimated cash flows from the equity investment received;
- market value, if any, of similar equity investments; and
- restrictions, if any, affecting payment of dividends, the sale of the investment or the repatriation of capital.

If the fair value of the equity investment received is less than the book value of the debt, the resultant loss should be recognized and charged to the allowance for loan losses and should include any discounts from the official exchange rate that are imposed as a transaction fee. All other fees relating to the debt/equity conversion should be charged to expense, rather than capitalized.

Will the recognition of a loss in a debt/equity conversion contaminate the remainder of a bank's loan portfolio with respect to that debtor or country? The Bulletin does not require that the remainder of the bank's debt be written down to the same value. The AICPA notes, however, that in accordance with Generally Accepted Accounting Principles (GAAP), a financial institution's loan portfolio should be carried at amortized historical cost less both loan write-offs and the allowance for loan losses, provided that the institution has the ability and intent to hold the loans until their maturity. Thus the bank need not mark down such debt to its "fair value" simply because of a debt/equity conversion. Loan write-offs and loan loss allowances are to be taken based on management's judgment regarding the ultimate collectibility of the loans in the normal course of business. The recognition of a loss on a debt/equity conversion should be one of the factors considered by management in its periodic assessment of the adequacy of its

32. Accounting Standards Executive Committee of the American Institute of Certified Public Accountants, Practice Bulletin No. 4 (May 1988).
allowance for loan losses. If, however, management demonstrates its intention to dispose of loans prior to maturity, the loan should be carried at cost or fair value, whichever is lower. Thus, the recognition of a loss on a debt/equity conversion will not require a bank to write down the remainder of its loans to the same borrower, but the occurrence of such recognition should be taken into account by the bank in determining the adequacy of its allowance for loan losses.

In practice, will this proposed treatment require more than an insignificant write-down of the value of the equity asset received? If the “fair value” of such equity must take into account the secondary market value of the debt given up, as well as the U.S. dollar value of a local currency-denominated equity interest that is not readily convertible into hard currency, it is possible that more than an insignificant loss will result. Thus, for an equity investment in Mexico acquired in exchange for debt selling at approximately 40 percent of par, the loss might well be 25 to 45 percent. If such is the case, some banks may be discouraged from undertaking debt/equity conversions until such time as their reserves are adequate to absorb such losses. Even then, they may prefer to hold on to such debt or, alternatively, to sell it, realize the loss, and no longer have to worry about their exposure to the developing country in question.

2. Debt-for-Debt Swaps

The market among banks for debt-for-debt swaps was severely dampened by the AICPA’s “Notice to Practitioners” of May 1985 and the OCC Banking Circular 200, both of which provided that a swap of loans to different debtors represented an exchange of monetary assets that should be accounted for at fair value. The OCC’s Circular went even further and stated that, for loan swaps involving loans to debtors of foreign countries that are currently experiencing financial difficulties, “it is presumed the estimated fair values will be less than the respective face values of the loans and other consideration [given up]. Assuming the general presumption is not overcome, this would result in a loss on the swap.”

Now that many banks have established substantial reserves for their Third World debt and have indicated a willingness to realize losses in dealing with such debt, it can be expected that there will be more debt-for-debt swapping. If, however, the loss realized in the swap of debt is quite similar to that which would be realized if the debt were simply sold for cash, banks may prefer to sell, rather than swap, their debt if they are prepared to realize the loss.

II. Some Suggestions for Structuring Equity Investments

In order to avoid some of the limitations placed upon U.S. banks by Regulation K and the BHCA on acquiring voting stock of nonfinancial entities,
and to avoid the restrictions imposed by certain debtor nations on foreign investment generally, investors may need to consider some creative structuring techniques.

Additionally, since the equity investments into which banks will be converting their debt will be subject not only to the vagaries of the profitability of such investments, but also to the risk of devaluation of the local currency, banks quite naturally will want to protect themselves as much as possible from both these risks. To reduce these risks a bank might concentrate on investments that have a high foreign exchange earning capability, such as the manufacture of exports and tourist resorts, or might obtain insurance, if available, from The Overseas Private Investment Corporation and the Multilateral Investment Guaranty Agency (especially for inconvertibility risks) in appropriate cases.

Such risks, as well as the limitations on acquiring voting stock imposed by Regulation K and the BHCA, may be alleviated by using a nonvoting preferred stock that has attributes similar to those of debt and adopting one or more of the following "bells and whistles":

1. The dividends on the preferred stock could be cumulative and mandatorily payable as soon as the venture has sufficient profits.

2. A sinking fund arrangement could be established into which funds would be deposited for subsequent use in paying dividends on, and ultimately redeeming, the preferred stock.

3. The issuer of the preferred stock could be an entity within an affiliated group that would be structured so that, even if the overall venture were not profitable, the particular entity issuing the preferred stock could be the beneficiary of contractual arrangements that would assure it sufficient profitability to service the dividends due on such stock.

4. To protect against the devaluation of the local currency, it might be possible to adjust or index the dividend and redemption payments so as to reflect inflation or changes in exchange rates. Alternatively, the preferred stock could have a bonus dividend that would compensate for losses due to devaluation.

Whether any of such arrangements will work in a particular country will depend upon local laws, the regulations applicable to debt/equity conversions, and regulations affecting remittances of foreign exchange in respect of dividends.

Because BHCs are generally limited by U.S. regulations to owning up to 25 (and under certain circumstances up to 40) percent of a company's voting stock (assuming the investments are not banking or financial in nature or are not necessary to prevent a loss on a debt previously contracted, in which case more voting stock may be acquired), they are logical minority partners for U.S. and other industrial companies that desire to establish or expand an operation in one of the debtor countries. By selling a minority equity interest to a bank, an industrial company can obtain outside financing in local currency (which at times may be otherwise difficult) at a relatively reasonable cost. By so doing, it can
also share the equity risks of investment with a minority partner with whom it feels comfortable. The banks, on the other hand, will also feel comfortable being a minority partner of an industrial company that will have operational control over the business and with which they may well have an existing customer relationship in the United States.

III. Securitization and Collateralization of Existing Debt: The Mexican Debt Exchange

Schemes to turn part of the LDC debt into securities that would be tradeable on a securities exchange, rather than merely in the informal secondary market for LDC debt, have been fantasized about by investment and commercial bankers, and their lawyers and accountants, for several years. Such schemes have frequently included credit enhancement devices, such as guarantees by multilateral financial institutions or collateral consisting of U.S. Treasury obligations. The goal has been to create a new instrument that, fulfilling the alchemist's dream, has a value in the market place exceeding the cost or value of its constituent components. The Mexican Debt Exchange, although not the only such scheme to see the light of day, is certainly the most ambitious and noteworthy to date.

A. The Basic Outline of the Mexican Debt Exchange

Pursuant to an Invitation for Bids, Mexico on January 18, 1988, offered to exchange a new issue of Mexican Collateralized Floating Rate Bonds Due 2008 (Bonds), denominated in U.S. dollars, paying interest at a floating rate and maturing in twenty years, in exchange for certain existing obligations of Mexico outstanding under its Restructure and New Money Agreements. The Bonds were to be secured, as to their principal only and not as to interest, by non-interest-bearing U.S. Treasury obligations (Zeroes), which were to be purchased by Mexico using its own reserves. The Zeroes were to be pledged to holders of the Bonds and have a maturity date and principal amount payable at maturity to match the maturity date and principal amount of the Bonds. In the event of a default under the Bonds, a bondholder would not have access to the Zeroes until the final, originally scheduled maturity date, at which time the proceeds of the Zeroes would be available to pay the principal of the Bonds at maturity.

Banks desiring to exchange their existing debt for Bonds were invited to submit bids on a voluntary basis to the exchange agent, Morgan Guaranty Trust Company of New York. In its bids, each bank was asked to specify the principal

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35. Invitation from Gustavo Petrocelli, Minister of Finance and Public Credit of the United Mexican States, to the Banks Party to Mexico's Public Sector Restructure and New Restructure Agreements and 1983 and 1984 New Money Agreements, to Exchange Existing Indebtedness for United Mexican States Collateralized Floating Rate Bonds Due 2008 (Jan. 18, 1988).
amount of eligible existing Mexican debt obligations (the Eligible Debt) that the bank was willing to tender and the principal dollar amount of Bonds that the bank would accept in exchange for such Eligible Debt. For example, a bank could state in its bid that it was willing to tender $10 million of Eligible Debt and would accept in exchange therefor Bonds with a principal dollar amount of $7 million, thereby indicating its willingness to accept a discount of the principal amount of its Eligible Debt equal to 30 percent.

To enhance their attractiveness to the banks and, ultimately, to third parties, the Bonds have the following features:

(i) The Bonds pay interest at a margin of 1½ percent above LIBOR, which is double the margin of 1¼ percent currently payable by Mexico on the Eligible Debt;

(ii) The Bonds are listed on the Luxembourg stock exchange;

(iii) The Bonds, according to Mexico, will not be subject to future restructurings or reschedulings that might otherwise apply to its Eligible Debt; and

(iv) Also according to Mexico, neither the Bonds nor the Eligible Debt given in exchange will be considered part of any base amount for purposes of future requests by Mexico for new money.

B. Consents and Waivers

In order to issue the Bonds, it was necessary for Mexico to obtain a waiver of the negative pledge provisions under its outstanding credit agreements and, in the case of one credit agreement that did not permit an exchange offer, even if unsecured, the waiver of mandatory prepayment and sharing provisions. In addition, it was necessary for Mexico to collateralize certain outstanding publicly held bond issues since it was not practicable to obtain a waiver of the negative pledge provisions relating to such issues.

C. The Results of the Bid

Mexico and Morgan Guaranty had publicly stated that they expected up to $20 billion of Eligible Debt would be tendered and, projecting that the banks would tender at a 40 to 50 percent discount, the total amount of new bonds issued was predicted to be as high as $10 billion. The results of the auction were much less dramatic. Over $6 billion of Eligible Debt was tendered, but Mexico accepted only those obligations tendered at an exchange ratio of 74.99 percent or less, with the result that Mexico accepted $3.67 billion of debt to be exchanged for $2.56 billion of Bonds. Thus, the average exchange ratio of the accepted bids was 69.77 percent. Upon completion of the exchange, Mexico will have succeeded in reducing its outstanding indebtedness by $1.1 billion, an amount substantially lower than the reduction of $10 billion originally envisioned. Although the results seem disappointing in light of such expectations, the
transaction justifiably deserves to be considered a moderate success, not only because it did achieve a reduction of Mexico’s debt of $1.1 billion, but also because it shows that debt securitization and collateralization schemes can play a significant role in the management and reduction of LDC debt.

D. ACCOUNTING TREATMENT OF THE MEXICAN DEBT EXCHANGE

Perhaps the two most important issues confronting the banks in evaluating the Mexican Debt Exchange were the accounting treatment of the exchange and the value that the marketplace would put on the Bonds. Three principal accounting issues were raised by the Exchange.

1. Accounting Treatment of the Exchange Itself

Price Waterhouse rendered an opinion to Morgan Guaranty on the appropriate accounting treatment for the transaction, concluding that the exchange of Eligible Debt for the Bonds should be treated as an exchange of monetary assets. As a result, a bank would recognize an accounting loss or gain equal to the difference between the carrying value of its Eligible Debt on its books prior to the exchange and the “fair value” of the Bonds received in exchange. Such loss should generally be recorded as a charge to the allowance for loan losses. The amount of the loss was affected not only by the discount factor at which a bank exchanged its Eligible Debt for the Bonds, but also by the amount by which the fair value of the Bonds received exceeded the face value of such Bonds.

“Fair value” normally is equal to market value if a broad-based, active market exists. Since it may take some time for such a market for the Bonds to develop, banks will need to use other appropriate valuation techniques, such as discounted cash flow analysis, to determine fair value.

Some accountants have argued that the Mexican Debt Exchange be treated not as an exchange of monetary assets with the Bonds being booked at “fair value,” but rather as part of a troubled debt restructuring pursuant to Statement of Financial Accounting Standards No. 15, “Accounting by Debtors and Creditors for Troubled Restructurings” (FAS No. 15). If the exchange of Bonds for Eligible Debt were considered a restructuring of the Eligible Debt, FAS No. 15 would not require a bank to write down the value of its restructured loan unless the amount of the loan on its books exceeded the total future cash receipts, including both principal and interest, to be received by the bank pursuant to the restructured terms of the debt. Since the total payments of principal plus interest over the twenty-year life of the Bonds would clearly exceed the recorded value of the Eligible Debt on the books of the banks prior to the exchange, no loss would be required to be recognized. It should be noted that FAS No. 15 has its critics.

36. Id. app. III (letter from Price Waterhouse).
37. FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING STANDARDS ORIGINAL PRONOUNCEMENTS 169.
2. Accounting Treatment of Debt Tendered but Not Accepted by Mexico

Under GAAP, a bank should carry a loan it has the intent and ability to hold to maturity at its historical cost less the allowance for loan losses. If, however, management clearly demonstrates its intent to dispose of a loan or a group of loans prior to maturity, then such loans should be carried at cost or market, whichever is lower. Because Price Waterhouse viewed the Mexican Debt Exchange as a unique opportunity, it concluded that if management does not have a present intention to dispose of the Eligible Debt other than through the tender offer, the mere act of tendering Eligible Debt that is not accepted by Mexico does not necessarily constitute a clear intention to dispose of such loans prior to maturity.

The staff of the Securities and Exchange Commission has, however, taken a contrary view in its Staff Accounting Bulletin No. 75 (SAB No. 75), which sets forth the SEC staff’s views regarding certain accounting disclosure issues applicable to the Mexican Debt Exchange. SAB No. 75 states:

The tender of the existing loans is an event that must be given accounting recognition either (i) by writing the loans down to the price at which the bank has agreed to accept Bonds in the tender (tender price) or (ii) by increasing, as necessary, the allowance for loan losses to an amount sufficient to result in a net carrying value of the loans tendered that equals the tender price.

3. Treatment of Debt Not Tendered to Mexico

Price Waterhouse opined that, even though a bank exchanges part of its Eligible Debt for Bonds and recognizes a loss on the exchange, the accounting treatment of the bank’s untendered Eligible Debt should not change solely by reason of the fact that a portion of the bank’s Eligible Debt was exchanged, so long as the bank has the ability and intent to hold such remaining loans to maturity. The SEC staff in SAB No. 75 did point out, however, that pursuant to Statement of Financial Accounting Standards No. 5, “Accounting for Contingencies,” management has a continuing responsibility to assess the adequacy of the allowance for loan losses relative to untendered Mexican debt to ensure that such allowance is adequate to provide for losses due to ultimate collectibility, including anticipated losses from the sale, swap, or other exchange of loans.

F. Securities Laws Aspects

The Bonds were issued in registered definitive form. They were not registered under U.S. securities laws, but were sold to U.S. persons pursuant to a private placement, with appropriate legends and restrictions on transfer. Bonds issued outside the United States to purchasers not U.S. persons were required, for a period of ninety days after issuance, not to be sold in the United States or to U.S. persons. The Bonds to be issued to non-U.S. persons were initially represented by a single, temporary global bond. Individual Bonds were issued to non-U.S.
persons ninety days after the closing date for the transaction upon appropriate antiflowback certifications by such persons.

G. SOME OBSERVATIONS ON THE MEXICAN DEBT EXCHANGE

The Mexican Debt Exchange deserves genuine recognition for blazing a new trail in the quest for solutions to the debt crisis. A number of criticisms and comments have, however, been put forth that should be taken into consideration and evaluated:

1. The fact that Mexico itself had to purchase with its own reserves the Zeroes to collateralize the Bonds renders the scheme impracticable to most developing countries, which have limited reserves.

2. The requirement by the SEC in SAB No. 75 that Eligible Debt tendered but not accepted by Mexico be written down to the tender price, or that sufficient loan-loss reserves be maintained to reflect a carrying value of such debt equal to the tender price, discouraged some banks from participating in the tender.

3. The transaction perhaps could have been structured to qualify as a FAS No. 15 troubled debt restructuring, thereby avoiding the immediate financial accounting loss suffered by banks that participated in the exchange.

4. Mexico was unrealistic in anticipating that banks would tender their Eligible Debt at a discount that, when combined with the market discount of the Bonds, would result in an overall discount in excess of that at which the Eligible Debt was trading in the secondary market.

5. The interest payable on the Bonds was purely Mexican credit risk, depressing the anticipated market price at which the Bonds would trade. Some credit enhancement, such as a one-year rolling forward guaranty as has been suggested by Secretary Brady, might be desirable to support Mexico's interest obligation.

With the financial and credit enhancement support that Secretary Brady has suggested will be forthcoming from the World Bank and the IMF, it is expected that new debt securitization and collateralization schemes will be proposed in reliance on credit support from such institutions.

IV. Conclusion

The substantial increase in loan-loss reserves and the overall strengthening of bank capital have provided banks with much greater flexibility in managing their LDC loan portfolio. Thus, banks are much more willing and able to realize the accounting losses that ordinarily follow from effecting debt/equity conversions, debt-for-debt swaps, or debt exchanges similar to that of the Mexican Exchange.

The Board's recent liberalization of Regulation K has alleviated to a certain extent one of the regulatory hurdles to debt/equity conversions. Such conversions
can be a powerful tool not only in reducing the LDC debt burden, as Chile has demonstrated, but also in serving as an engine of growth in encouraging new capital investment. Similarly, debt securitization and collateralization schemes can be quite effective in reducing the LDC debt burden while at the same time giving the banks, especially those seeking an exit vehicle from LDC lending, flexibility in determining whether to retain or liquidate their LDC debt.

These techniques and others currently being developed cannot, singly, be viewed as a "solution" to the LDC debt problem. However, taken together they can, if not unduly restricted by government regulations, accounting rules, and loan agreement provisions, produce a gradual reduction in the debt burden to a level that the principal debtor nations should be able to manage comfortably. It is hoped that, with the support of the U.S. Government, as demonstrated by Secretary Brady's announcement of a new U.S. policy initiative for dealing with the LDC debt problem, other OECD governments, the World Bank, and the IMF, the LDC nations will be able to achieve substantial debt reduction through debt/equity conversions, debt securitization and collateralization schemes, and other innovative transactions.